

DOW THEORY LETTERS INC.

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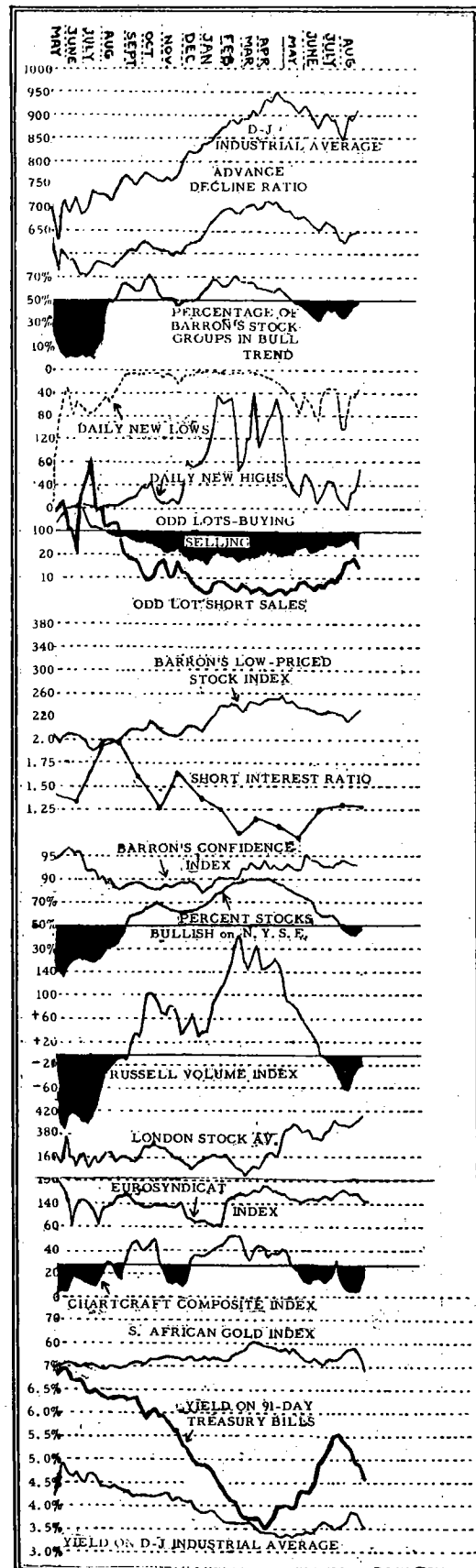
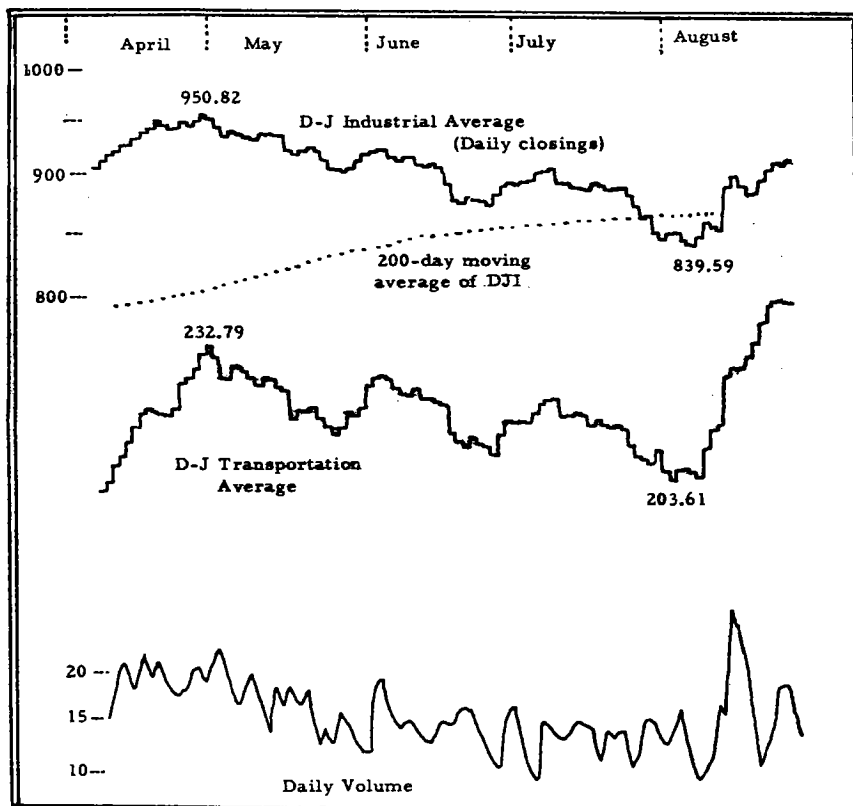
Letter 505

THE MARKET: Last week the three D-J common stock Averages were examined, and the conclusion was that the bellwether Utility Average has shown the most weakness during 1971. I drew attention to the huge "gaps" which had formed in the Averages on the explosive opening of Monday, August 16. During the next two days the Utility Average evidenced continuing weakness by closing the gap, but the other two Averages are still traveling with the yawning gaps of August 16 beneath them.

On August 23 a most interesting non-confirmation occurred (see chart below) as the Transportation Average pushed well above its April recovery peak of 232.79. The new 1971 high for the Transports found the Industrial Average roughly 50 points below its comparable April recovery peak of 950.82. On August 24 and 25 the Averages (excepting the Utilities) moved sharply higher and the whole pattern assumed a most extraordinary appearance.

It is worth going over a little recent history to provide a background for what may happen next. If you will refer to the page 2 chart of the Averages on a weekly basis (chart up-dated from Letter 504) you will note the major non-confirmation of December, 1968. This took place as the Transports bettered their 1966 bull market high. At that time, Industrials failed by 10 points to confirm. The result of this flagrant non-confirmation was the smashing decline of 1969-70.

Usually the stronger Average on any rally will perform best on the downside as well, and it was therefore most unusual when the Transports (the stronger Average since they alone rose to a record high in 1968) proved far weaker during the



Page 2 1969-70 crash
(this weakness
can be easily seen on the chart
on this page, which is drawn
to ratio scale).

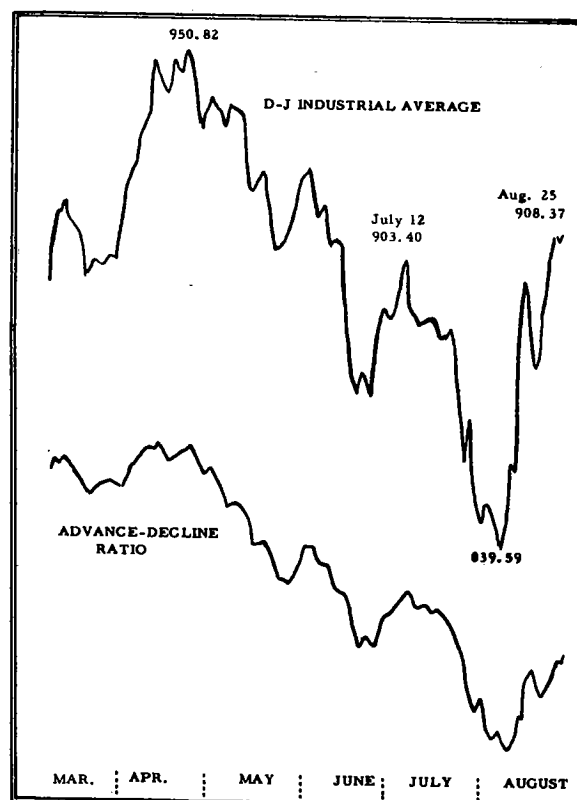
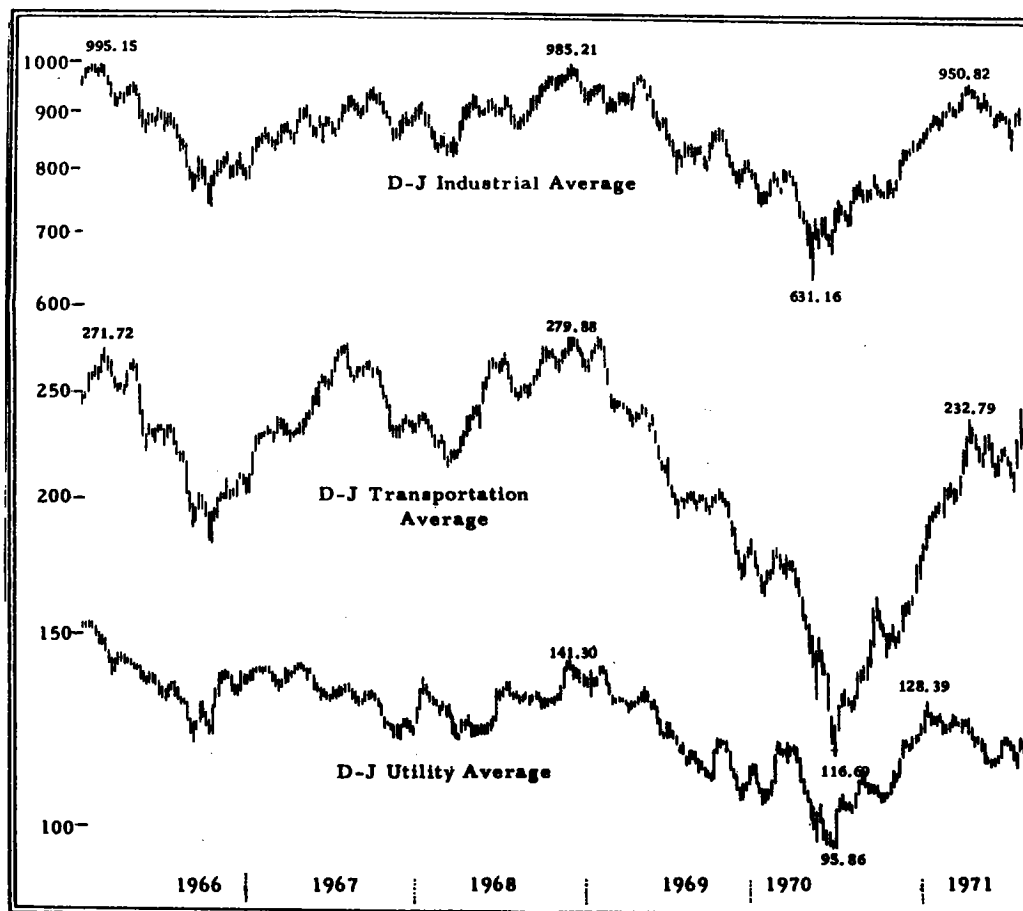
The downward movement
terminated in May, 1971. A
violent recovery set in, and
the Averages rallied through
to April, 1971 (the rally peaks
were 950.82 for Industrials,
232.79 for Transports). A
sharp and persistent decline
then carried through to August,
whereupon the most recent
advance commenced (the
advance actually began on
August 10, five days before the
Nixon "bombshell").

Now note that on August 23 the
Transports rose to new recovery
highs, but Industrials have (so
far) failed to confirm (by
bettering the April peak of
950.82). I would say that
unless Industrials shortly con-
firm by hurdling their own
April peak, the situation will
grow increasingly dangerous.

Subscribers may remember that the December, 1968 non-
confirmation was almost totally ignored by Wall Street, and so far
it appears to me that the current non-confirmation has been
similarly ignored.

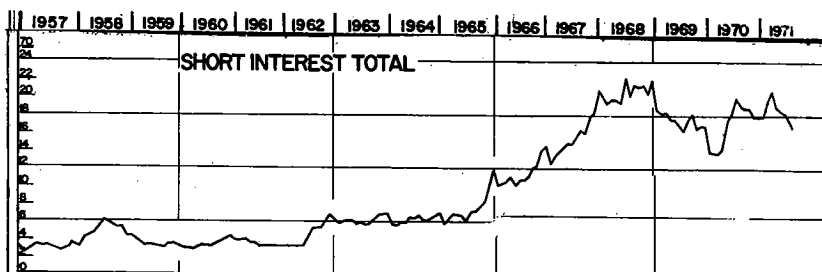
I will also draw attention to the fact that just as Industrials have
not confirmed the Transports at this juncture, we have another
non-confirmation in that the advance-decline ratio (see chart
on this page) has not confirmed the Industrial rally which on
August 25 bettered the July 12 peak of 903.40. The chart, in
fact, shows the wide discrepancy between the sharp Industrial
recovery (which nevertheless lagged the Transports) and the
substandard recovery in the A-D ratio. The explanation is that
broad selling pressure continued in the market and throughout the
rally, and this is best seen in the number of daily declines which
have tended to hold in the 400 to 500 class during most advancing
days. Thus, A-D ratio figures on the upside have been far from
spectacular, and this has led to the failure (so far) of the A-D
ratio to confirm the progress of Industrials.

It is a most fascinating situation with an outcome which is any-
thing but clear. Meanwhile, it is well to remember that this is
still a primary bear market, that the U.S. situation in the world
is changing radically, that we are currently witnessing great
enthusiasms during a bear rally (which is always a dangerous
phenomenon), and that we are now seeing a series in which the
A-D ratio has not confirmed the Industrial Average, and the
Industrial Average has not confirmed the Transportation Average,
and the bellwether Utility Average is lagging very badly.



"UNRAVELING" : In recent Letters I mentioned that as this primary bear market enters its second half, the market and the economy will experience an unraveling of the great ball of yarn that was the bull market of 1949-66.

Last week it was announced that the U.S. experienced a trade deficit in July, the fourth in a row and the first such string in 34 years. Thus, the trading position of the U.S. is slowly "coming apart" and it remains to be seen whether a 10% import surcharge will reverse the current, persistent trend.



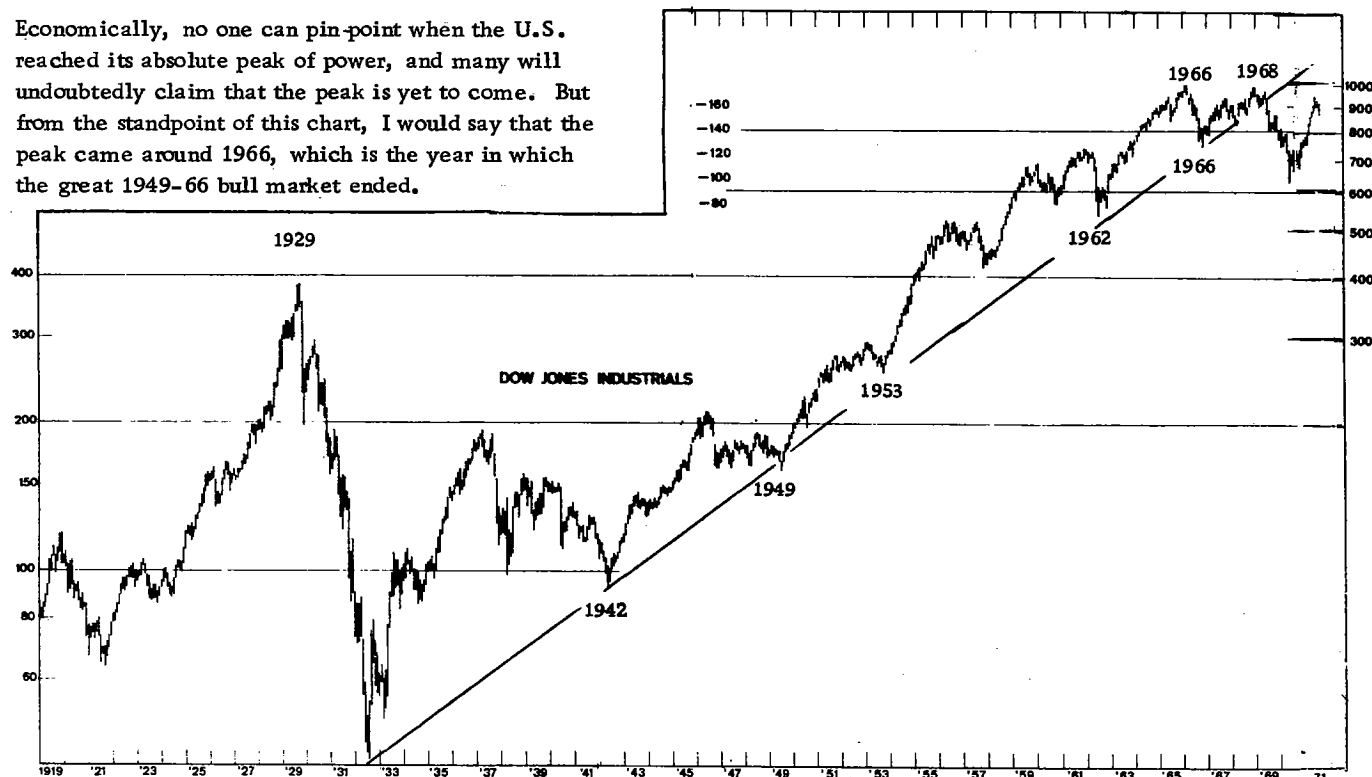
A second unraveling appears to be taking place in the mutual fund industry where the July figures show net redemptions (over sales) for the third month in a row. For years the mutual funds showed heavy net inflows of cash as purchases by the public far surpassed sales. Now, it seems possible that a major turn in the fund tide is at hand. E. George Schaefer (the famed Dow Theorist from Indianapolis) says, "Personally, I look for 5 years of net redemptions ahead for the mutual funds." If Schaefer is anywhere near right (and I happen to agree with him), the funds will provide persistent and probably increasing strength to the bear as the market ultimately plunges to major and undreamed of lows.

A third unraveling could well be the short interest on the N.Y.S.E., which just dropped to its lowest level in a year (see chart, courtesy of Dines Chart Corp. 18 E. 41st St., N.Y. 10017). The short position has been a big prop under the market for years, and since 1966 it has held over 12 million shares. I would consider any drop to 13 million or lower in the short position ominously bearish for this market.

THE RECEDING TIDE: I show here what I feel is a fascinating chart of the D-J Industrials covering the period from 1919 to the present (monthly high-lows on the Dow). Chart is courtesy of the Bank Credit Analyst.

On July 8, 1932, the Industrials halted their long decline in history's worst primary bear market at a price of 41.22. From that point, a series of bull and bear markets carried from the 1932 low to the 1937 and 1946 highs, then to the 1949 low of 161.60. From 1949 another great primary bull market took the Dow to an all-time high of 995.15 in 1966. Now the fantastic fact is that all the action from July 8, 1932, to the 1966 high took place at or above an ascending trendline, as seen on the chart. That trendline held from 1932 to 1968, or a period of 36 years. During that period it might be said that the U.S. was rising from the depths of depression through to World War II and onward to its peak of power.

Economically, no one can pin-point when the U.S. reached its absolute peak of power, and many will undoubtedly claim that the peak is yet to come. But from the standpoint of this chart, I would say that the peak came around 1966, which is the year in which the great 1949-66 bull market ended.



Page 4 The first primary bear market decline took the Dow to 744.32 in October, 1966. A major correction brought the Dow back to 985.21 in December, 1968. From there, the second broad downward leg of the bear market took the Dow to a May, 1971, low of 631.16. It was this second leg down that smashed the 36 year ascending trendline.

Now probably not one in a thousand investors and not one in a hundred economists realize that the entire rising trend in the Dow from 1932 to 1966 has been shattered. And if they did, I don't know whether they would attach any great significance to the event. However, I take the breaking of this great trendline as a most serious phenomenon, a warning of a reversal in the fortunes of the U.S. for perhaps years to come. It is probably no mistake that the trendline breaking came less than three years before the U.S. embargoed gold, which meant that the dollar (which for decades was considered by all the world to be as good as gold) was now a floating piece of fiat paper, a question mark, the value of which all the world will now debate.

It is also perhaps no accident that the U.S. is now led by a President who ran on a balance-the-budget platform, then ran up the biggest peace-time deficits in history (while announcing that he had become a Keynesian), then allowed inflation to run rampant while denouncing wage and price controls, and finally grabbed the whole Democratic economic platform, placed a 10% surcharge on imports, slapped on wage and price controls and cut the dollar's gold backing to zero.

Obviously, however, we can't blame the U.S.'s fortunes on a single President. The picture which appears on this chart is bigger than any President, Congress or Treasurer. It is the story of World War II and the Korean War and the Vietnam War, it's the story of giant military budgets and huge Government employment, it's the story of political manipulations and inflation and half-truths and hypocrisy and in many cases outright lies. It's the story of almost four decades of buying and borrowing and running up mammoth debts. And finally, it's the story of a primary bear market which took five years to even "get started".

That's the way I see this chart. I feel that it is an ominous picture in many ways, but perhaps a hopeful picture in other ways. For to me it marks the beginning of a reversal of the tide, the beginning of the end for deceit and pride and arrogance. And it may be pointing to a new world which will be immeasurably harder, but based on truth.

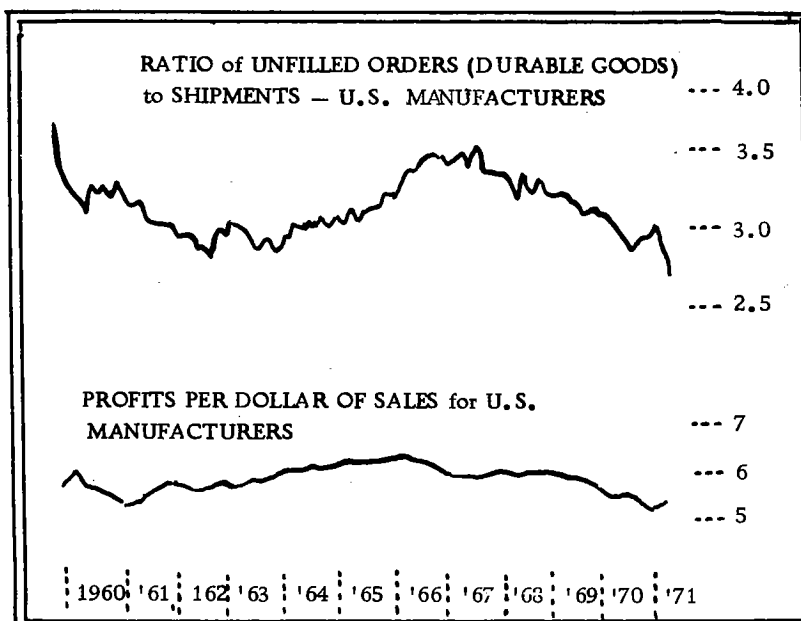
RATIOS: Economists, like market analysts, can always make a case for their own preconceived notions or wishes. Nevertheless, there are a number of fundamental indicators which I follow, and I like to follow these in chart form, since a chart always places the statistics in easily comparable, historical perspective.

The accompanying chart shows two very important indicators. The upper graph shows the ratio of unfilled orders (manufacturers' durable goods) to shipments. This ratio is now the lowest in decades. This is particularly interesting in view of the fact that factories in the U.S. are now running at around 73% of their actual capacity, which is the lowest operating rate since 1957.

With the unfilled orders (or backlogs) to shipments ratio so low, it is obvious that there must soon be an influx of new business to bolster the backlogs — or shipments are going to drop off as factories run out of work. This in turn will push the percentage of factory capacity in use to even lower levels. It will also, in turn, raise unemployment as factories shut down for lack of work.

The second graph line is also of utmost importance. It shows profits (after taxes) per dollar of sales by U.S. manufacturers. In the last quarter of 1970, this figure sank to 3.6%, the lowest profitability per dollar of sales in decades. During the first quarter of 1971 the indicator rose to 4% per dollar of sales, an improvement, but still the lowest figure since 1960.

What this figure means is that with inflation skyrocketing wages and increasing costs in just about every other area, the U.S. manufacturer has to run faster just to stand still. It means that any decline in actual dollar



volume of sales would practically wipe out profits, which are slim enough as is (even on today's huge volume).

My conclusion is that the U.S. economy is perched precariously on the edge of the abyss. Any major dislocation or sudden collapse in confidence could send volume and profits careening to lower levels. The consumer seems to sense this, and he is saving like mad for "a rainy day". For many, despite what seems like general prosperity across the country, it appears that the rains have arrived.

MUSINGS: I don't think I have ever received a greater mountain of incoming mail and reports than over the last two weeks. I would say that the great majority of these reports are bullish on President Nixon's plan (I don't think they call it a game plan anymore), and most believe it is simply a matter of time before the U.S. economy is on the road to nirvana. I disagree. I don't know why but one particular report sticks in my mind, perhaps because I felt the report was symbolic. It was the August "Monthly Economic Letter" from the prestigious First National City Bank (New York). The report contained a special reprint of an article by Paul McCracken, Chairman of the Council of Economic Advisers, and the piece represents Mr. McCracken's attempt to annihilate the case for wage and price controls (the case was put forth by Democratic economist J.K. Galbraith). The only problem was that the rather convincing McCracken article was mailed after the President had gone against his Council Chairman by actually instituting wage and price controls. Ah well, when economic chaos is here, one can't expect to get all the signals straight.

Evidently, I am not the only man alive who is pointing to the possibility of Russia seizing the "Chapter XI Bankruptcy on the U.S. Dollar" (as James Dines puts it) as a golden opportunity. E. George Schaefer wrote last week, "What worries me here, incidentally, are the recent veiled threats coming out of Russia concerning the possibility of a move to put the ruble — a gold-backed ruble — out in international trade. The thought of a gold ruble competing against a printing press dollar is too horrible to contemplate."

And from Zurich, the Myers' Finance Review states: "Russia watches. Watch Russia. They have not been mining gold at \$100 an oz. for years just to admire it. I have frequently said (no one else has yet) that when the U.S. goes off gold, Russia will go on. The gold convertible ruble now emerges as a possibility this year."

It is axiomatic in business that one should never make a move out of weakness. When President Nixon in one fell swoop overturned the world monetary system, he did not do it out of strength as he might have done, say during his first month in office (by doubling or tripling the price of gold and insisting on broad anti-inflation measures at the same time). No, the acts of August 15 were instituted out of crushing weakness, a collapsing dollar, huge trade deficits, and rocketing inflation. As a result, all the world was caught holding the dollar bag, a bag estimated at perhaps \$46 billions (in fiat or non-gold backed paper).

It was immediately assumed here that the U.S. would announce our desire for a revaluation of foreign currencies, and our trading partners would stampede to revalue, thereby making themselves less competitive in trade with the U.S. So far, however, it appears to be every man for himself with Germany floating the mark, France on a two-tier system and most of the other key world currencies floating. On August 27 Japan floated the yen after billions of dollars flooded into Japan, bringing her reserves up to an astounding \$12.5 billion (actually above the U.S.'s reserves)!

But to date not a single nation has officially revalued its currency, although Israel and Indonesia have done just the opposite with Israel devaluing by a full 20%. And despite U.S. claims of victory on the monetary front, the fact is that the whole picture is still very much up in the air.

I am afraid that Americans get a distorted idea of what's happening in the world (we live so far from the rest of the world), and I hasten to tell my readers that our friends overseas have not taken a

World in financial chaos

President Nixon's emergency measures have one primary merit. They ought to remove the last shreds of complacency among Governments and bankers about the state of the world's finances. The explosion has been some years in the making. During those years the US balance of payments has been going ever more deeply into the red. At first the deficit could be accounted

for by enormous military and foreign aid commitments around the world. The Vietnam war also was a heavy drain on US payments. But in the past year the United States has faced an unusual and growing deficit in its external trading account. This year will probably see the biggest trade deficit the US has known since 1893.

All this has happened during a period when countries abroad have become less and less willing to hold huge sums of dollars in lieu of goods and services the United States is unable to provide. Until now dissatisfied foreign central banks had been able to convert unwanted dollars into gold at \$35 per ounce. But, fed by fears that the US payments were going from bad to worse, claims have multiplied and the gold reserves have fallen to \$10,000 millions — or about 20 per cent of total foreign dollar claims on the United States.

Page 6 happy view of events since President Nixon's announcements. Perhaps the best pulse on events can be obtained by actually reading what foreigners say; thus I include this lead-off clip (page 5) from the widely-read Manchester Guardian Weekly (Britain).

I was actually surprised to see this opening to an article in the August 24 Wall Street Journal (back page, of course), although the article was boldly entitled, "Pressure Increases for Formal Devaluation". The piece starts, "President Nixon's roughshod shakeup of world currency markets is provoking fierce new pressure to formally devalue the dollar. The historic embarrassment of formal devaluation — that is, raising the official gold price of \$35 an ounce — is precisely what the President was trying to avoid by his Aug. 15 actions."

If there were any doubt about Europe's attitude on gold, it was dispersed on August 23 when IMF Director Schweitzer took to national television to state that "one contribution" the U.S. could make to international stability was official devaluation.

On August 24 at Geneva the 54-nation GATT meeting (General Agreement on Trade and Tariffs) warned the U.S. that it risked retaliatory tariffs and trade barriers in view of the new 10% U.S. surcharge. In fact, some noticed that retaliation had already appeared in the form of a united refusal to revalue currencies immediately as the U.S. requested. At the GATT meeting, high-ranking spokesman Ralf Dahrendorf (Commissioner for External Export) stated: "The community reiterates its conviction that the measures in the field of trade are inappropriate to remedy the serious difficulties that confront the American government...." But the entire GATT meeting appeared to be simply a preamble of the real conflicts which lie ahead as Europe hesitates to buckle down and do the U.S.'s bidding.

So far, the U.S. had adopted the attitude of putting a monkey-wrench in the gears and leaving the rest of the world to rebuild the engine. But massive problems are appearing such as the open split between Germany and France, and the probability that revaluations will collapse the European-Japanese boom. Another possibility is that Europe will refuse to revalue its currencies without a boost in the dollar price of gold. After all, by floating the dollar, Mr. Nixon has cost our creditors billions of dollars. They will want some sort of a pay-off, and a higher price for gold might suffice.

What will happen if the U.S. is successful in bringing about revaluations in all foreign currencies? My own feeling is that the pressure will then be on the U.S. to remove the 10% surcharge, and that further pressure will appear to remove wage-price controls (at least before election time). But the basic problems of the U.S., inefficiency and non-competitiveness, will linger on, and the problems of inflation will still be there (even if rendered "dormant" while wage-price controls are in force).

The fact is that Mr. Nixon has not solved any basic problems, and the measures and events he is aiming for are only bids for time. In his latest report, friend Harry Schultz (International Harry Schultz Letter) recalls the parallel of the 1930's. "After the financial crisis of the early 1930's Roosevelt tried to get the country going again by changing the dollar's relationship with the rest of the world. The reasons were much the same as today: severe competition from abroad, unemployment, fading foreign markets, feelings of uncertainty and even dismay over U.S. social unrest". Schultz notes that the 1934 formula lasted a few years, and then in 1937 the U.S. suffered one of its worst market and economic collapses, with the Dow breaking 50% in a matter of six months.

I was particularly struck this week by the Green's Commodity Market Comments since Mr. Stahl (their editor) is extremely knowledgeable and anything but a "gold bug". Says Stahl, "President Nixon's decision has taken us out of Bretton Woods but not out of the woods.... A new system will have to be devised, and this cannot be done overnight, considering that there are 188 members of the IMF and that each of them is affected by the new measures..... The unprecedented flight of the dollar to foreign havens, which is still continuing, must be stopped before any negotiations can begin. The official tier system for the gold market was effectively killed. But we do not believe that at present any workable monetary system can be devised without the use of gold as a reserve asset".

I close this section by saying that the U.S. is facing fundamental problems, not minor dislocations in the world commerce and monetary situation. When the steam pressure in the boiler rises, you can rip out the safety valve and hammer in a steel cap, but it won't be long before the boiler blows. In all the world's history, the problems of inflation and monetary debasement have never been solved (only temporarily held off) by controls or tariffs or monetary juggling. Meanwhile, U.S. prestige has been hurt badly, and the balance of power has moved farther from the U.S. and nearer to Europe than at any time since World War II. The late-September IMF meeting may provide an interesting insight into Europe's growing power and the diminishing power of the once impregnable U.S.